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MARITIME ADMINISTRATION

Weaknesses Identified in Management of the Title XI Loan Guarantee Program

Statement of Thomas J. McCool, Managing Director
Financial Markets and Community Investment

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Highlights

Highlights of GAO-03-728T, a testimony before the Committee on Commerce, Science, and Transportation, U.S. Senate

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Why GAO Did This Study

Title XI of the Merchant Marine Act of 1936, as amended, is intended to help promote growth and modernization of the U.S. merchant marine and U.S. shipyards by enabling owners of eligible vessels and shipyards to obtain financing at attractive terms. The program has guaranteed more than $5.6 billion in ship construction and shipyard modernization costs since 1993, but it has experienced several large-scale defaults over the past few years. One borrower, American Classic Voyages, defaulted on five loan guarantees in amounts totaling $330 million, the largest of which was for the construction of Project America cruise ships. Because of concerns about the scale of recent defaults, GAO was asked to (1) determine whether the Maritime Administration (MARAD) complied with key program requirements, (2) describe how MARAD's practices for managing financial risk compare to those of selected private-sector maritime lenders, and (3) assess MARAD's implementation of credit reform.

GAO is currently considering a number of recommendations to reform the Title XI program. Because of the fundamental flaws identified, GAO questions whether MARAD should approve new loan guarantees without first addressing these program weaknesses.

www.gao.gov/cgi-bin/getrpt?GAO-03-728T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Tom McCool at (202) 512-8678 or mccoolt@gao.gov.

What GAO Found

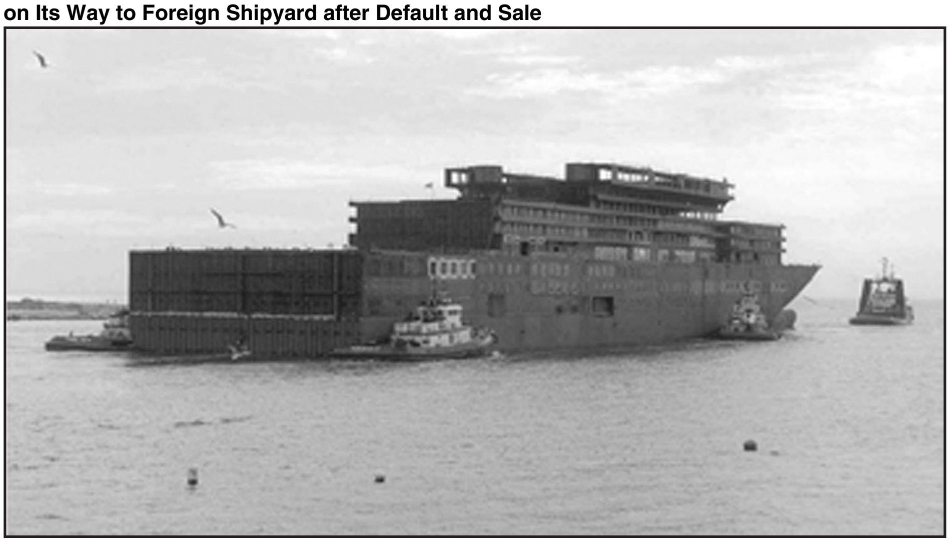
MARAD has not fully complied with some key Title XI program requirements. While MARAD generally complied with requirements to assess an applicant's economic soundness before issuing loan guarantees, MARAD did not ensure that shipowners and shipyard owners provided required financial statements, and it disbursed funds without sufficient documentation of project progress. Overall, MARAD did not employ procedures that would help it adequately manage the financial risk of the program.

MARAD could benefit from following the practices of selected private-sector maritime lenders. These lenders separate key lending functions, offer less flexibility on key lending standards, use a more systematic approach to loan monitoring, and rely on experts to estimate the value of defaulted assets.

With regard to credit reform implementation, MARAD uses a simplistic cash flow model to calculate cost estimates, which have not reflected recent experience. If this pattern of recent experience were to continue, MARAD would have significantly underestimated the cost of the program.

MARAD does not operate the program in a businesslike fashion. Consequently, MARAD cannot maximize the use of its limited resources to achieve its mission and the program is vulnerable to fraud, waste, abuse, and mismanagement. Also, because MARAD's subsidy estimates are questionable, Congress cannot know the true costs of the program.

Partially Completed Project America Cruise Ship Financed under Title XI Program on Its Way to Foreign Shipyard after Default and Sale



Source: Northrop Grumman Corporation Ship Systems Ingalls Operations.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the results of our review of the Maritime Administration's (MARAD) Title XI loan guarantee program. Title XI was created to help promote growth and modernization of the U.S. merchant marine and U.S. shipyards by enabling owners of eligible vessels and shipyards to obtain long-term financing on terms and conditions that might not otherwise be available. Under the program, MARAD guarantees the payment of principal and interest to purchasers of bonds issued by vessel and shipyard owners. These owners may obtain guaranteed financing for up to 87.5 percent of the total cost of buying or constructing a vessel or buying or modernizing a shipyard.

Under Title XI, MARAD committed to guarantee more than $5.6 billion in shipyard modernization and ship construction projects over the last 10 years. During this period, MARAD experienced nine defaults on these loan guarantee commitments totaling over $1.3 billion. The defaulted amounts associated with these nine loan guarantee commitments totaled $489 million.[1] Five of these defaults were by subsidiaries of American Classic Voyages Company (AMCV), a shipowner. AMCV defaults represented 67 percent of all defaulted amounts experienced by MARAD during this period, with this borrower having defaulted on guaranteed loan projects in amounts totaling $330 million. The largest loan guarantee ever approved by MARAD, for over $1.1 billion, was for Project America, Inc., a subsidiary of AMCV. Project America, Inc., had entered into a contract in March 1999 with Northrup Grumman Corporation (formerly Litton Ingalls Shipbuilding) in Pascagoula, Mississippi, for the construction of two cruise ships. In October 2001, AMCV filed for bankruptcy, defaulting on $187 million in loan guarantees associated with Project America.

As of December 31, 2002, MARAD's portfolio included approximately $3.4 billion in executed loan guarantees, representing 103 projects for 818 vessels and four shipyard modernizations.[2] At the end of fiscal year 2002, MARAD had approximately $20 million in unexpended, unobligated budget authority that had been appropriated in prior years. In its 2004 budget, the administration requested no new funds for the Title XI program.

[1]Defaulted amounts may include disbursed loan guarantee funds, interest accrued, and other costs.

[2]Loan guarantees are legal obligations to pay off debt if an applicant defaults on a loan..

While Title XI of the Merchant Marine Act of 1936, as amended, established the requirements of the loan guarantee program, the loan guarantees are also subject to the Federal Credit Reform Act of 1990 (FCRA). Under the FCRA, federal agencies must account for the estimated costs of direct and guaranteed loans on a net present value basis, over the full term of the credit, and agencies must receive appropriations for these costs before they disburse a loan or enter into loan guarantee commitments.

Because of concerns about the scale of recent defaults experienced by MARAD, particularly those associated with AMCV, you asked us to conduct a study of the Title XI loan guarantee program. Specifically, you asked us to (1) determine whether MARAD complied with key Title XI program requirements in approving initial and subsequent agreements, monitoring and controlling funds, and handling defaults; (2) describe how MARAD's practices for managing financial risk compare to those of selected private-sector maritime lenders; and (3) assess MARAD's implementation of credit reform as it relates to the Title XI program.

To determine whether MARAD complied with key Title XI program requirements, we identified key program requirements and reviewed how these were applied to the management of five loan guarantee projects. To determine how MARAD's practices for managing financial risk compare to those of selected private-sector maritime lenders, we interviewed three maritime lenders to learn about lending practices, and compared these practices to MARAD's. To assess MARAD's implementation of credit reform, we analyzed MARAD's subsidy cost estimation and reestimation processes and examined how the assumptions MARAD uses to calculate subsidy cost estimates compare to MARAD's actual program experience. We conducted our work in Washington, D.C., and New York, N.Y., between September 2002 and April 2003 in accordance with generally accepted government auditing standards.

In summary:

- MARAD has not fully complied with some key Title XI program requirements. We found that MARAD generally complied with requirements to assess an applicant's economic soundness before issuing loan guarantees. However, MARAD used waivers or modifications, which, although permitted by MARAD regulations, allowed MARAD to approve some applications even though borrowers had not met all financial requirements. MARAD did not fully comply with regulations and established practices pertaining to project monitoring and fund disbursement. Finally, while MARAD has guidance governing the disposition of defaulted assets, adherence to this guidance is not mandatory, and MARAD did not always follow it in the defaulted cases we reviewed.

- Private-sector maritime lenders we interviewed told us that to manage financial risk, they among other things: (1) establish a clear separation of duties for carrying out different lending functions; (2) adhere to key lending standards with few, if any, exceptions; (3) use a more systematic approach to monitoring the progress of projects; and (4) primarily employ independent parties to survey and appraise defaulted projects. They try to be very selective when originating loans for the shipping industry. MARAD could benefit from considering the internal control practices employed by the private sector to more effectively utilize its limited resources while maximizing its ability to accomplish its mission.

- MARAD uses a relatively simplistic cash flow model that is based on outdated assumptions, which lack supporting documentation, to prepare its estimates of defaults and recoveries. While the nature and characteristics of the Title XI program make it difficult to estimate subsidy costs, MARAD has not performed the basic analyses necessary to assess and improve its estimates, which differ significantly from recent actual experience. Specifically, we found that in comparison with recent actual experience, MARAD's default estimates have significantly understated defaults, and its recovery estimates have significantly overstated recoveries. Agencies should use sufficient reliable historical data to estimate credit subsidies and update—reestimate—these estimates annually based on an analysis of actual program experience. However, MARAD has never evaluated the performance of its loan guarantee projects to determine if its subsidy cost reestimates were comparable to actual costs. Finally, the Office of Management and Budget (OMB) has provided little oversight of MARAD's subsidy cost estimate and reestimate calculations.

Because MARAD does not operate the Title XI loan guarantee program in a businesslike fashion, it lacks assurance that it is effectively promoting growth and modernization of the U.S. merchant marine and U.S. shipyards or minimizing the risk of financial loss to the federal government. Consequently, the Title XI program could be vulnerable to waste, fraud, abuse, and mismanagement. Also, MARAD's questionable subsidy cost estimates do not provide Congress a basis for knowing the true costs of the Title XI program and Congress cannot make well-informed policy decisions when providing budget authority. If the pattern of recent experiences were to continue, MARAD would have significantly underestimated the costs of the program.

To review our findings in more detail, let me start by describing MARAD's management of the Title XI program.

MARAD Has Not Fully Complied with Some Key Title XI Program Requirements

MARAD has not fully complied with some key Title XI program requirements. We found that MARAD generally complied with requirements to assess an applicant's economic soundness before issuing loan guarantees. However, MARAD used waivers or modifications, which, although permitted by MARAD regulations, allowed MARAD to approve some applications even though borrowers had not met all financial requirements. Additionally, MARAD did not fully comply with regulations and established practices pertaining to project monitoring and fund disbursement. Finally, while MARAD has guidance governing the disposition of defaulted assets, adherence to this guidance is not mandatory, and MARAD did not always follow it in the defaulted cases we reviewed. We looked at five MARAD-financed projects (see table 1).

Table 1: Projects Included in Our Review

Project	Year loan committed	Original amount (millions)	Risk category	Status
(AMCV) Project America, Inc.	1999	$1,079.5	2A	Default
Searex	1996	$77.3	2B	Default
Massachusetts Heavy Industries (MHI)	1997	$55.0	3	Default
Hvide Van Ommeran Tankers (HVIDE)	1996	$43.2	2C	Active
Global Industries	1996	$20.3	1C	Active

Source: MARAD data.

Note: MARAD places projects into one of seven risk categories that, from lowest to highest, are 1A, 1B, 1C, 2A, 2B, 2C, and 3.

MARAD Used Waivers and Modifications to Approve Loans That Would Otherwise Not Be Approved

MARAD regulations do not permit MARAD to guarantee a loan unless the project is determined to be economically sound.[3] MARAD generally complied with requirements to assess an applicant's economic soundness before approving loan guarantees, and we were able to find documentation addressing economic soundness criteria for the projects included in our review. Specifically, we were able to find documentation addressing supply and demand projections and other economic soundness criteria for the projects included in our review.[4] In 2002, MARAD's Office of Statistical and Economic Analysis found a lack of a standardized approach for conducting market analyses. Because of this concern, in November 2002, it issued guidance for conducting market research on marine transportation services. However, adherence to these guidelines is not required. Finally, while MARAD may not waive economic soundness criteria, officials from the Office of Statistics and Economic Analysis expressed concern that their findings regarding economic soundness might not always be fully considered when MARAD approved loan guarantees.[5] They cited a recent instance where they questioned the economic soundness of a project that was later approved without their concerns being addressed. According to the Associate Administrator for Shipbuilding, all concerns, including economic soundness concerns, are considered by the MARAD Administrator.

Shipowners and shipyard owners are also required to meet certain financial requirements during the loan approval process. However, MARAD used waivers or modifications, which, although permitted by Title XI regulations, allowed MARAD to approve some applications even though

[3]All projects must be determined to be economically sound, and borrowers must have sufficient operating experience and the ability to operate the vessels or employ the technology on an economically sound basis. Particularly, MARAD regulations contain language stating that (1) long-term demand must exceed supply; (2) documentation must be provided on the projections of supply and demand; (3) outside cash flow should be shown, if in the short-term the borrower is unable to service indebtedness; and (4) operating cash flow ratio must be greater than one (sufficient cash flow to service the debt).

[4]Economic soundness analyses are prepared by the Office of Subsidy and Insurance and the Office of Statistical and Economic Analysis. It should be noted that we did not assess the substance of these economic analyses.

[5]In another case, Congress statutorily waived economic soundness criteria. Specifically, the Coast Guard Authorization Act of 1996 contained a provision waiving the economic soundness requirement for reactivation and modernization of certain closed shipyards in the United States. Previously, MARAD had questioned the economic soundness of the MHI proposal and rejected the application.

borrowers had not met all financial requirements that pertained to working capital, long-term debt, net worth, and owner-invested equity[6] For example, AMCV's Project America, Inc., did not meet the qualifying requirements for working capital, among other things. Although MARAD typically requires companies to have positive working capital, an excess of current assets over current liabilities, the accounting requirements for unterminated passenger payments significantly affect this calculation because this deferred revenue is treated as a liability until earned. [7] Because a cruise operator would maintain large balances of current liabilities, MARAD believed it would be virtually impossible for AMCV to meet a positive working capital requirement if sound cash management practices were followed.[8] Subsequently, MARAD used cash flow tests for Project America, Inc., in lieu of working capital requirements for purposes of liquidity testing.

According to MARAD officials, waivers or modifications help them meet the congressional intent of the Title XI program, which is to promote the growth and modernization of the U. S. merchant marine industry. Further, they told us that the uniqueness of the Title XI projects and marine financing lends itself to the use of waivers and modifications. However, by waiving or modifying financial requirements, MARAD officials may be taking on greater risk in the loans they are guaranteeing. Consequently, the use of waivers or modifications could contribute to the number or severity of loan guarantee defaults and subsequent federal payouts. In a recent review, the Department of Transportation Inspector General (IG) noted that the use of modifications increases the risk of the loan guarantee to the government and expressed concern about MARAD undertaking such modifications without taking steps to mitigate those risks.[9] The IG recommended that MARAD require a rigorous analysis of the risks from modifying any loan approval criteria and impose compensating requirements on borrowers to mitigate these risks.

[6]MARAD may waive or modify financial terms or requirements upon determining that there is adequate security for the guarantees.

[7]Unterminated passengers are individuals who pay for a cruise, but do not actually take the cruise, and the payment is not refunded. However, the passenger may take the trip at a later date.

[8]Cash management is a financial management technique used to accelerate the collection of debt, control payments to creditors, and efficiently manage cash.

[9]U.S. Department of Transportation, Office of Inspector General, *Maritime Administration Title XI Loan Guarantee Program* (Washington, D.C.: Mar. 27, 2003).

MARAD Did Not Follow Requirements for Monitoring the Financial Condition of Projects and for Controlling the Disbursement of Loan Funds

MARAD did not fully comply with requirements and its own established practices pertaining to project monitoring and fund disbursement. Program requirements specify periodic financial reporting, controls over the disbursement of loan funds, and documentation of amendments to loan agreements. MARAD could not always demonstrate that it had complied with financial reporting requirements. In addition, MARAD could not always demonstrate that it had determined that projects had made progress prior to disbursing loan funds. Also, MARAD broke with its own established practices for determining the amount of equity a shipowner must invest prior to MARAD making disbursements from the escrow fund.[10] MARAD did so without documenting this change in the loan agreement. Ultimately, weaknesses in MARAD's monitoring practices could increase the risk of loss to the federal government.

MARAD regulations specify that the financial statements of a company in receipt of a loan guarantee shall be audited at least annually by an independent certified public accountant. In addition, MARAD regulations require companies to provide semiannual financial statements. However, MARAD could not demonstrate that it had received required annual and semiannual statements. For example, MARAD could not locate several annual or semiannual financial statements for the Massachusetts Heavy Industries (MHI) project. Also, MARAD could not find the 1999 and 2000 semiannual financial reports for AMCV. The AMCV financial statements were later restated, as a result of a Securities and Exchange Commission (SEC) finding that AMCV had not complied with generally accepted accounting principles in preparing its financial statements.[11] In addition, several financial statements were missing from MARAD records for Hvide Van Ommeran Tankers (HVIDE) and Global Industries Ltd. When MARAD could provide records of financial statements, it was unclear how the information was used. Further, the Department of Transportation IG in its review of the Title XI program found that MARAD had no established procedures or policies incorporating periodic reviews of a company's financial well-being once a loan guarantee was approved.

[10]An escrow fund is an account in which the proceeds from sales of MARAD-guaranteed obligations are held until requested by the borrower to pay for activities related to the construction of a vessel or shipyard project or to pay interest on obligations.

[11]On June 25, 2001, AMCV restated losses from $6.1 million to $9.1 million for the first quarter of 1999.

An analysis of financial statements may have alerted MARAD to financial problems with companies and possibly given it a better chance to minimize losses from defaults. For example, between 1993 and 2000, AMCV had net income in only 3 years and lost a total of $33.3 million. Our analysis showed a significant decline in financial performance since 1997. Specifically, AMCV showed a net income of $2.4 million in 1997, with losses for the next 3 years, and losses reaching $10.1 million in 2000. Although AMCV's revenue increased steadily during this period by a total of 25 percent, or nearly $44 million, expenses far outpaced revenue during this period. For example, the cost of operations increased 29 percent, or $32.3 million, while sales and general and administrative costs increased over 82 percent or $33.7 million. During this same period, AMCV's debt also increased over 300 percent. This scenario combined with the decline in tourism after September 11, 2001, caused AMCV to file for bankruptcy. On May 22, 2001, Ingalls notified AMCV that it was in default of its contract due to nonpayment. Between May 22 and August 23, 2001, MARAD received at least four letters from Ingalls, the shipbuilder, citing its concern about the shipowner's ability to pay construction costs. However, it was not until August 23 that MARAD prepared a financial analysis to help determine the likelihood of AMCV or its subsidiaries facing bankruptcy or another catastrophic event.

MARAD could not always demonstrate that it had linked disbursement of funds to progress in ship construction, as MARAD requires. We were not always able to determine from available documents the extent of progress made on the projects included in our review. For example, a number of Project America, Inc.'s, disbursement requests did not include documentation that identified the extent of progress made on the project. Also, while MARAD requires periodic on-site visits to verify the progress on ship construction or shipyard refurbishment, we did not find evidence of systematic site visits and inspections. For Project America, Inc., MARAD did not have a construction representative committed on site at Ingalls Shipyard, Inc., until May 2001, 2 months after the MARAD's Office of Ship Design and Engineering Services recommended a MARAD representative be located on-site. For the Searex Title XI loan guarantee, site visits were infrequent until MARAD became aware that Ingalls had cut the vessels into pieces to make room for other projects. For two projects rated low-risk, Hvide Van Ommeran Tankers and Global Industries, Ltd., we found MARAD conducted site visits semiannually and annually, respectively. We reviewed MHI's shipyard modernization project, which was assigned the highest risk rating, and found evidence that construction representatives conducted monthly site visits. However, in most instances, we found that a project's risk was not linked to the extent of project monitoring. Further, MARAD relied on the shipowner's certification of money spent in making decisions to approve disbursements from the escrow fund.

We also found that, in a break with its own established practice, MARAD permitted a shipowner to define total costs in a way that permitted earlier disbursement of loan funds from the escrow fund. MARAD regulations require that shipowners expend from their own funds at least 12.5 percent or 25 percent, depending on the type of vessel or technology, of the actual cost of a vessel or shipyard project prior to receiving MARAD-guaranteed loan funds. In practice, MARAD has used the estimated total cost of the project to determine how much equity the shipowner should provide. In the case of Project America, Inc., the single largest loan guarantee in the history of the program, we found that MARAD permitted the shipowner to exclude certain costs in determining the estimated total costs of the ship at various points in time, thereby deferring owner-provided funding while receiving MARAD-guaranteed loan funds. This was the first time MARAD used this method of determining equity payments, and MARAD did not document this agreement with the shipowner as required by its policy. In September 2001, MARAD amended the loan commitment for this project, permitting the owner to further delay the payment of equity. By then, MARAD had disbursed $179 million in loan funds. Had MARAD followed its established practice for determining equity payments, the shipowner would have been required to provide an additional $18 million. Because MARAD had not documented its agreements with AMCV, the amount of equity the owner should have provided was not apparent during this period. Further, MARAD systems do not flag when the shipowner has provided the required equity payment for any of the projects it finances.

MARAD officials cited several reasons for its limited monitoring of Title XI projects, including insufficient staff resources and travel budget restrictions. For example, officials of MARAD's Office of Ship Construction, which is responsible for inspection of vessels and shipyards, told us that they had only two persons available to conduct inspections, and that the office's travel budget was limited. The MARAD official with overall responsibility for the Title XI program told us that, at a minimum, the Title XI program needs three additional staff. The Office of Ship Financing needs two additional persons to enable a more through review of company financial statements and more comprehensive preparation of credit reform materials. Also, the official said that the Office of the Chief Counsel needs to fill a long-standing vacancy to enable more timely legal review. With regard to documenting the analysis of financial statements, MARAD officials said that, while they do require shipowners and shipyard owners to provide financial statements, they do not require MARAD staff to prepare a written analysis of the financial condition of the Title XI borrower.

Inconsistent monitoring of a borrower's financial condition limits MARAD's ability to protect the federal government's financial interests. For example, MARAD would not know if a borrower's financial condition had changed so that it could take needed action to possibly avoid defaults or minimize losses. Further, MARAD's practices for assessing project progress limit its ability to link disbursement of funds to progress made by shipowners or shipyard owners. This could result in MARAD disbursing funds without a vessel or shipyard owner making sufficient progress in completing projects. Likewise, permitting project owners to minimize their investment in MARAD-financed projects increases the risk of loss to the federal government.

MARAD Does Not Have Requirements in Place to Govern the Handling of Defaulted Assets

MARAD has guidance governing the disposition of defaulted assets. However, MARAD is not required to follow this guidance, and we found that MARAD does not always adhere to it. MARAD guidelines state that an independent, competent marine surveyor or MARAD surveyor shall survey all vessels, except barges, as soon as practicable, after the assets are taken into custody. In the case of filed or expected bankruptcy, an independent marine surveyor should be used. In the case of Searex, MARAD conducted on-site inspections after the default. However, these inspections were not conducted in time to properly assess the condition of the assets. With funds no longer coming in from the project, Ingalls cut the vessels into pieces to make it easier to move the vessels from active work-in-process areas to other storage areas within the property. The Searex lift boat and hulls were cut before MARAD inspections were made. According to a MARAD official, the cutting of one Searex vessel and parts of the other two Searex vessels under construction reduced the value of the defaulted assets. The IG report on the Title XI program released in March 2003 noted that site visits were conducted on guaranteed vessels or property only in response to problems or notices of potential problems from third parties or from borrowers.

The guidelines also state that sales and custodial activities shall be conducted in such a fashion as to maximize MARAD's overall recovery with respect to the asset and debtor. Market appraisals (valuations) of the assets shall be performed by an independent appraiser, as deemed appropriate, to assist in the marketing of the asset. Relying on an interested party in determining the value of defaulted assets may not have maximized MARAD's financial recovery. In the case of Project America I and II, MARAD relied on the shipbuilder, Ingalls, to provide an estimate of the cost of making the Project America I vessel seaworthy. According to MARAD officials, their only option was to rely on Ingalls to provide this estimate. Ingalls' initial estimate in April 2002 was $16 million. Based on this estimate, MARAD rejected two bids to purchase the unfinished hull of Project America I ($2 million and $12 million respectively).[12] Subsequently, on May 17, 2002, MARAD advised Ingalls that it should dispose of the assets of Project America I and remit the net savings, if any, to MARAD. In a June 28, 2002, agreement between Northrup Grumman Ship Systems, Inc. (formerly Litton Ingalls Shipbuilding), Northrup Grumman advised that it would cost between $9 and $12 million to preserve and make Project America I seaworthy for delivery to the prospective purchaser. Had the $9 to $12 million estimate been made earlier in April 2002, MARAD would have accepted the $12 million dollar bid and would have disposed of the Project America I asset. By accepting Ingalls' original estimate of $16 million to make the ship seaworthy, MARAD may have incurred several months of unnecessary preservation expenses and possibly lowered its recovery amount. According to MARAD officials, as of March 2003, MARAD had received $2 million from the sale of the Project America I and II vessels.

Rather than obtaining a market appraisal to assist in marketing the asset, MARAD hired the Defense Contract Audit Agency (DCAA) to verify the costs incurred by Northrop Grumman Ship Systems, Inc., since January 1, 2002, for preparing and delivering Project America I in a weathertight condition suitable for ocean towing in international waters. A MARAD official said that the DCAA audit would allow MARAD to identify any unsupported costs and recover these amounts from the shipyard. The DCAA review was used to verify costs incurred, but not to make a judgment as to the reasonableness of the costs. DCAA verified costs of approximately $17 million.

MARAD officials cite the uniqueness of the vessels and projects as the reason for using guidelines instead of requirements for handling defaulted assets. However, certain practices for handling defaulted assets can be helpful regardless of the uniqueness of a project. Among these are steps to immediately assess the value of the defaulted asset. Without a definitive

[12]The bids were for the purchase of the unfinished hull for Project America I in seaworthy condition.

strategy and clear requirements, defaulted assets may not always be secured, assessed, and disposed of in a manner that maximizes MARAD's recoveries—resulting in unnecessary costs and financial losses to the federal government.

MARAD Techniques to Manage Financial Risk Contrast to Techniques of Selected Private-sector Maritime Lenders

Private-sector maritime lenders we interviewed told us that it is imperative for lenders to manage the financial risk of maritime lending portfolios. In contrast to MARAD, they indicated that to manage financial risk, among other things, they (1) establish a clear separation of duties for carrying out different lending functions; (2) adhere to key lending standards with few, if any, exceptions; (3) use a more systematic approach to monitoring the progress of projects; and (4) primarily employ independent parties to survey and appraise defaulted projects. The lenders try to be very selective when originating loans for the shipping industry. While realizing that MARAD does not operate for profit, it could benefit from the internal control practices employed by the private sector to more effectively utilize its limited resources and to enhance its ability to accomplish its mission. Table 2 describes the key differences in private-sector and MARAD maritime lending practices used during the application, monitoring, and default and disposition phases.

Table 2: Comparison of Private-sector and MARAD Maritime Lending Practices

Private-sector practices	MARAD practices
Phases of the lending process	
Application	
• Permit few exceptions to key financial underwriting requirements for maritime loans • Seek approval of exceptions or waivers from Audit Committee • Perform an in-depth analysis of a business plan for applications received for start-up businesses or first-in-class shipyard vessels	• Permit waivers of key financial requirements • Have no committee oversight regarding the approval of exceptions or waivers of program requirements • Employ little variation in the depth of review of business plans based on type of vessel, size of loan guarantee, or history of borrower
Monitoring	
• Set an initial risk rating at the time of approval and review rating annually to determine risk rating of the loan • Use industry expertise for conducting periodic on-site inspections to monitor progress on projects and potential defaults • Perform monitoring that is dependent on financial and technical risk, familiarity with the shipyard, and uniqueness of the project • Analyze the borrower's financial statements to identify significant changes in borrower's financial condition and to determine appropriate level and frequency of continued monitoring at least annually	• Assign one risk rating during the application phase. No subsequent ratings assigned during the life of the loan • Use in-house staff to conduct periodic on-site inspections to monitor progress of projects • Perform monitoring based on technical risk, familiarity with shipyard, uniqueness of project, and availability of travel funds • Have no documentation of analyses of borrowers' financial statements
Default and disposition	
• Contract with an independent appraiser to prepare a valuation of a defaulted project • Enlist a technical manager to review the ship after default to assist in determining structural integrity and percentage of completion	• Permit an interested party or MARAD official to value assets • Permit an interested party or MARAD official to perform technical review of Title XI assets

Sources: GAO analysis of MARAD and private-sector data.

Private-sector Lenders Separate Key Lending Functions

Private-sector lenders manage financial risk by establishing a separation of duties to provide a system of checks and balances for important maritime lending functions. Two private-sector lenders indicated that there is a separation of duties for approving loans, monitoring projects financed, and disposing of assets in the event of default. For example, marketing executives from two private-sector maritime lending institutions stated that they do not have lending authority. Also, separate individuals are responsible for accepting applications and processing transactions for loan underwriting.

In contrast, we found that the same office that promotes and markets the MARAD Title XI program also has influence and authority over the office that approves and monitors Title XI loans. In February 1998, MARAD created the Office of Statistical and Economic Analysis in an attempt to obtain independent market analyses and initial recommendations on the impact of market factors on the economic soundness of projects. This office reports to the Associate Administrator for Policy and International Trade rather than the Associate Administrator for Shipbuilding. However, the Associate Administrator for Shipbuilding also is primarily responsible for overseeing the underwriting and approving of loan guarantees. Title XI program management is primarily handled by offices that report to the Associate Administrator for Shipbuilding. In addition, the same Associate Administrator controls, in collaboration with the Chief of the Division of Ship Financing Contracts Office within the Office of the Chief Counsel, the disposition of assets after a loan has defaulted. Most recently, MARAD has taken steps to consolidate responsibilities related to loan disbursements. In August 2002, the Maritime Administrator gave the Associate Administrator for Shipbuilding sole responsibility for reviewing and approving the disbursement of escrow funds. According to a senior official, prior to August 2002 this responsibility was shared with the Office of Financial and Rate Approvals under the supervision of the Associate Administrator for Financial Approvals and Cargo Preference. As a result of the consolidation, the same Associate Administrator who is responsible for underwriting and approving loan guarantees and disposing of defaulted assets is also responsible for approval of loan disbursements and monitoring financial condition. MARAD undertook this consolidation in an effort to improve performance of analyses related to the calculation of shipowner's equity contributions and monitoring of changes in financial condition. However, as mentioned earlier, MARAD does not have controls for clearly identifying the shipowner's required equity contribution. The consolidation of responsibilities for approval of loan disbursements does not address these weaknesses and precludes any potential benefit from separation of duties.

Private-sector Practices Employ Less Flexible Lending Standards

The private-sector lenders we interviewed said they apply rigorous financial tests for underwriting maritime loans. They analyze financial statements such as balance sheets, income statements, and cash flow statements, and use certain financial ratios such as liquidity and leverage ratios that indicate the borrower's ability to repay. Private-sector maritime lenders told us they rarely grant waivers, or exceptions, to underwriting requirements or approve applications when borrowers do not meet key minimum requirements. Each lender we interviewed said any approved applicants were expected to demonstrate stability in terms of cash on hand, financial strength, and collateral. One lender told us that on the rare occasions when exceptions to the underwriting standards were granted, an audit committee had to approve any exception or waiver to the standards after reviewing the applicant's circumstances. In contrast, we found in the cases we reviewed that MARAD often permits waivers or modifications of key financial requirements, often without a deliberative process, according to a MARAD official. For example, MARAD waived the equity and working capital financial requirements at the time of the loan guarantee closing for MHI's shipyard modernization project. Also, a recent IG report found that MARAD routinely modifies financial requirements in order to qualify applicants for loan guarantees. Further, the IG noted that MARAD reviewed applications for loan guarantees primarily with in-house staff and recommended that MARAD formally establish an external review process as a check on MARAD's internal loan application review.[13] A MARAD official told us that MARAD is currently developing the procedures for an external review process.

These private-sector lenders also indicated that preparing an economic analysis or an independent feasibility study assists in determining whether or not to approve funding based on review and discussion of the marketplace, competition, and project costs. Each private-sector lender we interviewed agreed that performance in the shipping industry was cyclical and timing of projects was important. In addition, reviewing historical data provided information on future prospects for a project. For example, one lender uses these economic analyses to evaluate how important the project will be to the overall growth of the shipping industry. Another lender uses the economic analyses and historical data to facilitate the sale of a financed vessel. In the area of economic soundness analysis, MARAD requirements appear closer to those of the private-sector lenders, in that external market studies are also used to help determine the overall economic soundness of a project. However, assessments of economic soundness prepared by the Office of Statistical and Economic Analysis may not be fully considered when MARAD approves loan guarantees.

Private-sector Lenders Use a More Systematic Approach to Loan Monitoring

Private-sector lenders minimized financial risk by establishing loan monitoring and control mechanisms such as analyzing financial statements and assigning risk ratings. Each private-sector lender we interviewed said that conducting periodic reviews of a borrower's financial statements helped to identify adverse changes in the financial condition of the borrower. For example, two lenders stated that they annually analyzed

[13]The IG also recommended that MARAD impose compensating factors for loan guarantees to mitigate risks.

financial statements such as income statements and balance sheets. The third lender evaluated financial statements quarterly. Based on the results of these financial statement reviews, private-sector lenders then reviewed and evaluated the risk ratings that had been assigned at the time of approval. Two lenders commented that higher risk ratings indicated a need for closer supervision, and they then might require the borrower to submit monthly or quarterly financial statements. In addition, a borrower might be required to increase cash reserves or collateral to mitigate the risk of a loan. Further, the lender might accelerate the maturity date of the loan. Private-sector lenders used risk ratings in monitoring overall risk, which in turn helped to maintain a balanced maritime portfolio.

At MARAD, we found no evidence that staff routinely analyzed or evaluated financial statements or changed risk categories after a loan was approved. For example, we found in our review that for at least two financial statement reporting periods, MARAD was unable to provide financial statements for the borrower, and, in one case, one financial statement was submitted after the commitment to guarantee funds. Our review of the selected Title XI projects indicated that risk categories were primarily assigned for purposes of estimating credit subsidy costs at the time of application, not for use in monitoring the project. Further, we found no evidence that MARAD changed a borrower's risk category when its financial condition changed. In addition, neither the support office that was initially responsible for reviewing and analyzing financial statements nor the office currently responsible maintained a centralized record of the financial statements they had received. Further, while one MARAD official stated that financial analyses were performed by staff and communicated verbally to top-level agency officials, MARAD did not prepare and maintain a record of these analyses.

Private-sector lenders also manage financial risk by linking the disbursement of loan funds to the progress of the project. All the lenders we interviewed varied project monitoring based on financial and technical risk, familiarity with the shipyard, and uniqueness of the project. Two lenders thought that on-site monitoring was very important in determining the status of projects. Specifically, one lender hires an independent marine surveyor to visit the shipyard to monitor construction progress. This lender also requires signatures on loan disbursement requests from the shipowner, shipbuilder, and loan officer before disbursing any loan funds. This lender also relies on technical managers and classification society representatives who frequently visit the shipyard to monitor progress.[14] Shipping executives of this lender make weekly, and many times daily, calls to shipowners to further monitor the project based on project size and complexity. This lender also requires shipowners to provide monthly progress reports so the progress of the project could be monitored.

MARAD also relied on site visits to verify construction progress. However, the linkage between the progress of the project and the disbursement of loan funds was not always clear. MARAD tried to adjust the number of site visits based on the amount of the loan guarantee, the uniqueness of project (for example, whether the ship is the first of its kind for the shipowner), the degree of technical and engineering risk, and familiarity with the shipyard. However, the frequency of site visits was often dependent upon the availability of travel funds, according to a MARAD official.

Private-sector Lenders Use Industry Expertise to Value Defaulted Assets

Private-sector maritime lenders said they regularly use independent marine surveyors and technical managers to appraise and conduct technical inspections of defaulted assets. For example, two lenders hire independent marine surveyors who are knowledgeable about the shipbuilding industry and have commercial lending expertise to inspect the visible details of all accessible areas of the vessel, as well as its marine and electrical systems. In contrast, we found that MARAD did not always use independent surveyors. For example, we found that for Project America, the shipbuilder was allowed to survey and oversee the disposition of the defaulted asset. As mentioned earlier, MARAD hired DCAA to verify the costs incurred by the shipbuilder to make the defaulted asset ready for sale; however, MARAD did not verify whether the costs incurred were reasonable or necessary. For Searex, construction representatives and officials from the Offices of the Associate Administrator of Shipbuilding and the Chief of the Division of Ship Financing Contracts were actively involved in the disposition of the assets.

[14] Classification society representatives are individuals who inspect the structural and mechanical fitness of ships and other marine vessels for their intended purpose.

MARAD Cites Mission as the Difference in Management of Financial Risk Compared to Private-sector Lenders

According to top-level MARAD officials, the chief reason for the difference between private-sector and MARAD techniques for approving loans, monitoring project progress, and disposing of assets is the public purpose of the Title XI program, which is to promote growth and modernization of the U.S. merchant marine and U.S. shipyards. That are, MARAD's program purposefully provides for greater flexibility in underwriting in order to meet the financing needs of shipowners and shipyards that otherwise might not be able to obtain financing. MARAD is also more likely to work with borrowers that are experiencing financial difficulties once a project is under way. MARAD officials also cited limited resources in explaining the limited nature of project monitoring.

While program flexibility in financial and economic soundness standards may be necessary to help MARAD meet its mission objectives, the strict use of internal controls and management processes is also important. Otherwise, resources that could have been used to further the program might be wasted. To aid agencies in improving internal controls, we have recommended that agencies identify the risks that could impede their ability to efficiently and effectively meet agency goals and objectives.[15] Private-sector lenders employ internal controls such as a systematic review of waivers during the application phase and risk ratings of projects during the monitoring phase. However, MARAD does neither. Without a more systematic review of underwriting waivers, MARAD might not be giving sufficient consideration to the additional risk such decisions represent. Likewise, without a systematic process for assessing changes in payment risk, MARAD cannot use its limited monitoring resources most efficiently. Further, by relying on interested parties to estimate the value of defaulted loan assets, MARAD might not maximize the recovery on those assets. Overall, by not employing the limited internal controls it does possess, and not taking advantage of basic internal controls such as those private-sector lenders employ, MARAD cannot ensure it is effectively utilizing its limited administrative resources or the government's limited financial resources.

[15] U.S. General Accounting Office, *Standards for Internal Control in the Federal Government*, GAO/AIMD- 00-21.3.1 (Washington, D.C.: November 1999) and *Internal Control Management and Evaluation Tool*, GAO 01-1008G (Washington, D.C.: August 2001).

MARAD's Credit Subsidy Estimates and Reestimates Are Questionable

MARAD uses a relatively simplistic cash flow model that is based on outdated assumptions, which lack supporting documentation, to prepare its estimates of defaults and recoveries. These estimates differ significantly from recent actual experience. Specifically, we found that in comparison with recent actual experience, MARAD's default estimates have significantly understated defaults, and its recovery estimates have significantly overstated recoveries. If the pattern of recent experience were to continue, MARAD would have significantly underestimated the costs of the program. Agencies should use sufficient reliable historical data to estimate credit subsidies and update—reestimate—these estimates annually based on an analysis of actual program experience. While the nature and characteristics of the Title XI program make it difficult to estimate subsidy costs, MARAD has never performed the basic analyses necessary to determine if its default and recovery assumptions are reasonable. Finally, OMB has provided little oversight of MARAD's subsidy cost estimate and reestimate calculations.

MARAD's Credit Subsidy Estimates Are Questionable

The Federal Credit Reform Act of 1990 (FCRA) was enacted, in part, to require that the federal budget reflect a more accurate measurement of the government's subsidy costs for loan guarantees.[16] To determine the expected cost of a credit program, agencies are required to predict or estimate the future performance of the program. For loan guarantees, this cost, known as the subsidy cost, is the present value of estimated cash flows from the government, primarily to pay for loan defaults, minus estimated loan guarantee fees paid and recoveries to the government. Agency management is responsible for accumulating relevant, sufficient, and reliable data on which to base the estimate and for establishing and using reliable records of historical credit performance. In addition, agencies are supposed to use a systematic methodology to project expected cash flows into the future. To accomplish this task, agencies are instructed to develop a cash flow model, using historical information and various assumptions including defaults, prepayments, recoveries, and the timing of these events, to estimate future loan performance.

MARAD uses a relatively simplistic cash flow model, which contains five assumptions—default amount, timing of defaults, recovery amount, timing

[16]The Federal Accounting Standards Advisory Board developed the accounting standard for credit programs, Statement of Federal Financial Accounting Standards No. 2, "Accounting for Direct Loans and Loan Guarantees," which generally mirrors FCRA and which established guidance for estimating the cost of guaranteed loan programs.

of recoveries, and fees—to estimate the cost of the Title XI loan guarantee program. We found that relatively minor changes in these assumptions can significantly affect the estimated cost of the program and that, thus far, three of the five assumptions, default and recovery amounts and the timing of defaults, differed significantly from recent actual historical experience.[17] According to MARAD officials, these assumptions were developed in 1995 based on actual loan guarantee experience of the previous 10 years and have not been evaluated or updated. MARAD could not provide us with supporting documentation to validate its estimates, and we found no evidence of any basis to support the assumptions used to calculate these estimates. MARAD also uses separate default and recovery assumptions for each of seven risk categories to differentiate between levels of risk and costs for different loan guarantee projects.

We attempted to analyze the reliability of the data supporting MARAD's key assumptions, but we were unable to do so because MARAD could not provide us with any supporting documentation for how the default and recovery assumptions were developed. Therefore, we believe MARAD's subsidy cost estimates to be questionable. Because MARAD has not evaluated its default and recovery rate assumptions since they were developed in 1995, the agency does not know whether its cash flow model is reasonably predicting borrower behavior and whether its estimates of loan program costs are reasonable.

The nature and characteristics of the Title XI program make it difficult to estimate subsidy costs. Specifically, MARAD approves a small number of guarantees each year, leaving it with relatively little experience on which to base estimates for the future. In addition, each guarantee is for a large dollar amount, and projects have unique characteristics and cover several sectors of the market. Further, when defaults occur, they are usually for large dollar amounts and may not take place during easily predicted time frames. Recoveries may be equally difficult to predict and may be affected by the condition of the underlying collateral. This leaves MARAD with relatively limited information upon which to base its credit subsidy estimates. Also, MARAD may not have the resources to properly implement credit reform. MARAD officials expressed frustration that they

[17] MARAD's recovery assumption assumes a 50 percent recovery rate within 2 years of default. However, 2 years have not yet elapsed for several of the defaults and so we could not yet determine how the estimated timing of recoveries compares to the actual timing of recoveries.

do not have and, therefore, cannot devote, the necessary time and resources to adequately carry out their credit reform responsibilities.

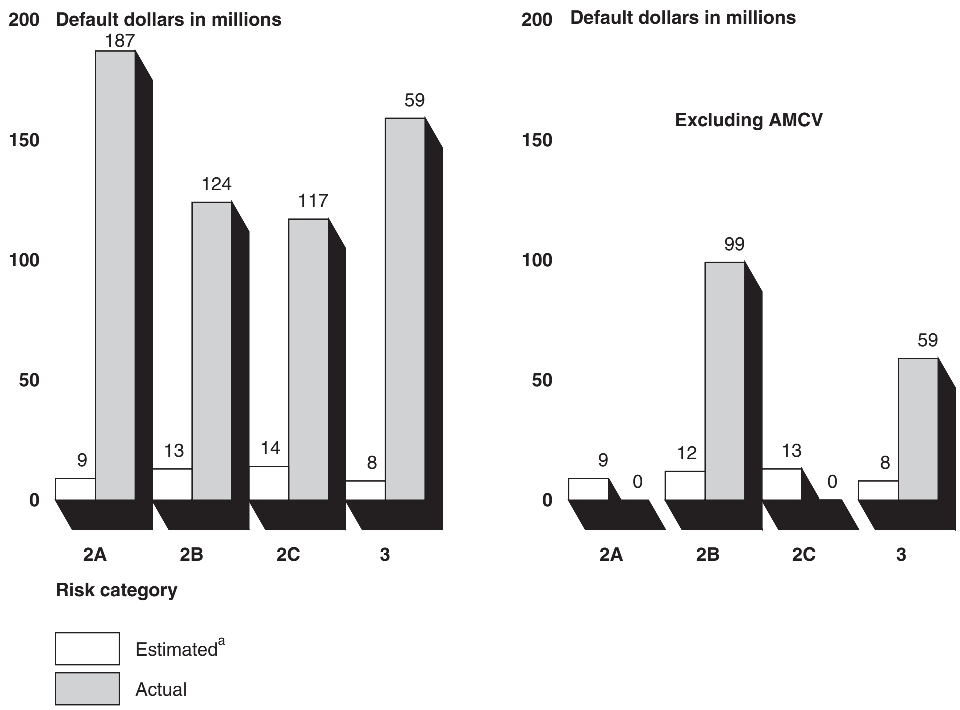
Notwithstanding these challenges, MARAD has not performed the basic analyses necessary to assess and improve its estimates. According to MARAD officials, they have not analyzed the default and recovery rates because most of their loan guarantees are in about year 7 out of the 25-year term of the guarantee, and it is too early to assess the reasonableness of the estimates. We disagree with this assessment and believe that an analysis of the past 5 years of actual default and recovery experience is meaningful and could provide management with valuable insight into how well its cash flow models are predicting borrower behavior and how well its estimates are predicting the loan guarantee program's costs. We further believe that, while difficult, an analysis of its risk category system is meaningful for MARAD to ensure that it appropriately classified loan guarantee projects into risk category subdivisions that are relatively homogenous in cost.

Of loans originated in the past 10 years, nine have defaulted, totaling $489.5 million in defaulted amounts. Eight of these nine defaults, totaling $487.7 million, occurred since MARAD implemented its risk category system in 1996. Because these eight defaults represent the vast majority (99.6 percent) of MARAD's default experience, we compared the performance of all loans guaranteed between 1996–2002 with MARAD's estimates of loan performance for this period.[18] We found that actual loan performance has differed significantly from agency estimates. For example, when defaults occurred, they took place much sooner than estimated. On average, defaults occurred 4 years after loan origination, while MARAD had estimated that, depending on the risk category, peak defaults would occur between years 10–18. Also, actual default costs thus far have been much greater than estimated. We estimated, based on MARAD data, that MARAD would experience $45.5 million in defaults to date on loans originated since 1996. However, as illustrated by figure 1, MARAD has consistently underestimated the amount of defaults the Title XI program would experience. In total, $487.7 million has actually defaulted during this period—more than 10 times greater than estimated.

[18]Our analysis focused on loans beginning in 1996 because (1) this was the first year in which MARAD implemented its risk category system, and (2) MARAD could not provide us with any supporting data for its default and recovery assumptions for loans originating before 1996. Further, only one default occurred between 1993–1996, representing less than 1 percent of MARAD's total defaults between 1993–2002.

Even when we excluded AMCV, which represents about 68 percent of the defaulted amounts, from our analysis, we found that the amount of defaults MARAD experienced greatly exceeded what MARAD estimated it would experience by $114.6 million (or over 260 percent).

Figure 1: Estimated and Actual Defaults of Title XI Loan Guarantees (1996–2002)

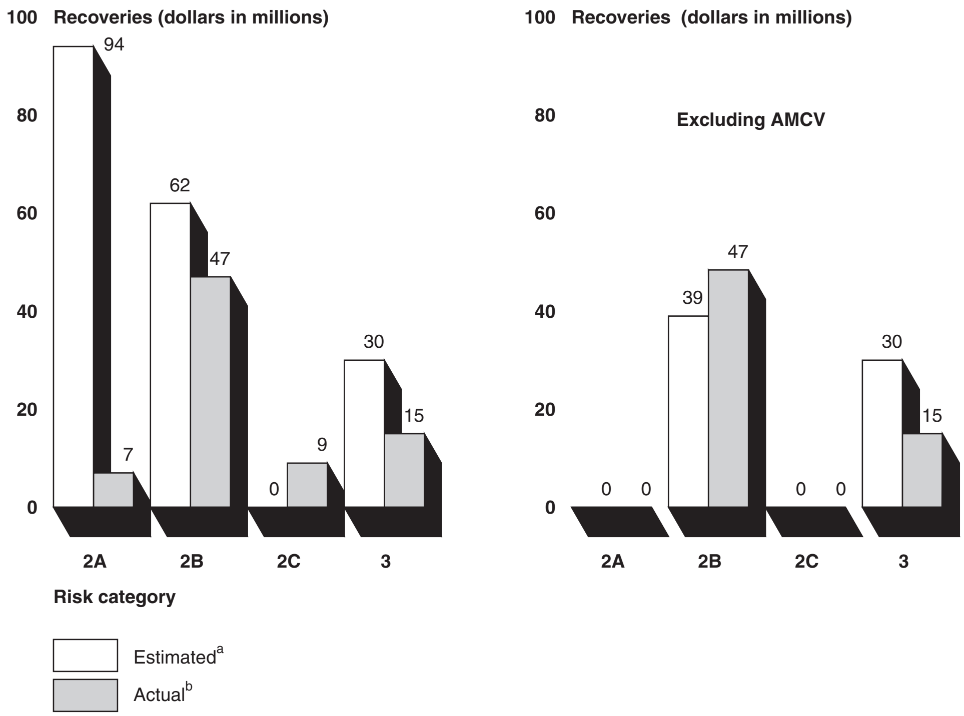


Sources: MARAD (data); GAO (presentation).

[a]We excluded estimates for risk categories 1A, 1B, and 1C, because estimated defaults for these categories totaled only $1.5 million or 3.4 percent of total estimated defaults.

In addition, MARAD's estimated recovery rate of 50 percent of defaulted amounts within 2 years of default is greater than the actual recovery rate experienced since 1996, as can be seen in figure 2. Although actual recoveries on defaulted amounts since 1996 have taken place within 1–3 years of default, most of these recoveries were substantially less than estimated, and two defaulted loans have had no recoveries to date. For the actual defaults that have taken place since 1996, MARAD would have estimated, using the 50 percent recovery rate assumption, that it would recover approximately $185.3 million dollars. However, MARAD has only recovered $78.2 million or about 42 percent of its estimated recovery amount. Even when we excluded AMCV, which represents about 68 percent of the defaulted amounts, from our analysis, we still found that MARAD has overestimated the amount it would recover on defaulted loans by $6.8 million (or about 10 percent). If this pattern of recent default and recovery experiences were to continue, MARAD would have significantly underestimated the costs of the program.

Figure 2: Estimated and Actual Recoveries on Title XI Loan Defaults (1996–2002)



Sources: MARAD (data); GAO (presentation).

[a]Estimated recoveries are based on applying MARAD's 50 percent recovery rate within 2 years to the actual default amounts. Our analysis of recovery estimates includes estimated recovery amounts for two of the five defaulted AMCV loans, even though 2 years have not elapsed, because, according to MARAD officials, no additional recoveries are expected on these two loans. Thus, our recovery calculation was based on $370.6 of the $487.7 million in defaulted loans, which includes defaults for which 2 years have elapsed, as well as the two AMCV defaults for which no additional recoveries are expected. With its 50 percent recovery assumption, MARAD would have estimated that, at this point, it should have recovered $185.3 million of these defaulted loans.

[b]We calculated the actual recovery rate by comparing the total actual recoveries to the $370.6 million in relevant actual defaulted amounts. At the time of our review, MARAD had recovered $78.2 out of this $370.6 million.

We also attempted to analyze the process MARAD uses to designate risk categories for projects, but were unable to do so because the agency could not provide us with any documentation about how the risk categories and MARAD's related numerical weighting system originally were developed.[19] According to OMB guidance, risk categories are subdivisions of a group of loans that are relatively homogeneous in cost, given the facts known at the time of designation. Risk categories combine all loan guarantees within these groups that share characteristics that are statistically predictive of defaults and other costs. OMB guidance states that agencies should develop statistical evidence based on historical analysis concerning the likely costs of expected defaults for loans in a given risk category. MARAD has not done any analysis of the risk category system since it was implemented in 1996 to determine whether loans in a given risk category share characteristics that are predictive of defaults and other costs and thereby comply with guidance. In addition, according to a MARAD official, MARAD's risk category system is partially based on outdated MARAD regulations and has not been updated to reflect changes to these regulations.

Further, MARAD's risk category system is flawed because it does not consider concentrations of credit risk. To assess the impact of concentration risk on MARAD's loss experience, we analyzed the defaults for loans originated since 1996 and found that five of the eight defaults, totaling $330 million or 68 percent of total defaults, involved loan guarantees that had been made to one particular borrower, AMCV. Assessing concentration of credit risk is a standard practice in private-sector lending. According to the Federal Reserve Board's Commercial Bank Examination Manual, limitations imposed by various state and federal legal lending limits are intended to prevent an individual or a relatively small group from borrowing an undue amount of a bank's resources and to safeguard the bank's depositors by spreading loans among a relatively large number of people engaged in different businesses. Had MARAD factored concentration of credit into its risk category system, it would likely have produced higher estimated losses for these loans.

MARAD's Credit Subsidy Reestimates Are Also Questionable

After the end of each fiscal year, OMB generally requires agencies to update or "reestimate" loan program costs for differences among estimated loan performance and related cost, the actual program costs

[19] MARAD's risk category system incorporates ten factors that are set out in Title XI, which specifies that MARAD is to establish a system of risk categories based on these factors. How MARAD weighs and interprets these factors is described in program guidance.

recorded in accounting records, and expected changes in future economic performance. The reestimates are to include all aspects of the original cost estimate such as prepayments, defaults, delinquencies, recoveries, and interest. Reestimates allow agency management to compare original budget estimates with actual costs to identify variances from the original estimates, assess the reasonableness of the original estimates, and adjust future program estimates, as appropriate. When significant differences between estimated and actual costs are identified, the agency should investigate to determine the reasons behind the differences, and adjust its assumptions, as necessary, for future estimates and reestimates.

We attempted to analyze MARAD's reestimate process, but we were unable to do so because the agency could not provide us with any supporting data on how it determined whether a loan should have an upward or downward reestimate. According to agency management, each loan guarantee is reestimated separately based on several factors including the borrower's financial condition, a market analysis, and the remaining balance of the outstanding loans. However, without conducting our own independent analysis of these and other factors, we were unable to determine whether any of MARAD's reestimates were reasonable. Further, MARAD has reestimated the loans that were disbursed in fiscal years 1993, 1994, and 1995 downward so that they now have negative subsidy costs, indicating that MARAD expects these loans to be profitable. However, according to the default assumptions MARAD uses to calculate its subsidy cost estimates, these loans have not been through the period of peak default, which would occur in years 10–18 depending on the risk category. MARAD officials told us that several of these loans were paid off early, and the risk of loss in the remaining loans is less than the estimated fees paid by the borrowers. However, MARAD officials were unable to provide us with any supporting information for its assessment of the borrowers' financial condition and how it determined the estimated default and recovery amounts to assess the reasonableness of these reestimates. Our analysis of MARAD's defaults and recoveries demonstrates that, when defaults occur, they occur sooner and are for far greater amounts than estimated, and that recoveries are smaller than estimated. As a result, we question the reasonableness of the negative subsidies for the loans that were disbursed in fiscal years 1993, 1994, and 1995.

MARAD's ability to calculate reasonable reestimates is seriously impacted by the same outdated assumptions it uses to calculate cost estimates as well as by the fact that it has not compared these estimates with the actual default and recovery experience. As discussed earlier, our analysis shows that, since 1996, MARAD has significantly underestimated defaults and overestimated recoveries to date. Without performing this basic analysis, MARAD cannot determine whether its reestimates are reasonable and it is unable to improve these reestimate calculations over time and provide Congress with reliable cost information to make key funding decisions. In addition, and, again, as discussed earlier, MARAD's inability to devote sufficient resources to properly implement credit reform appears to limit its ability to adequately carry out these credit reform responsibilities.

OMB Has Provided Little Oversight of MARAD's Estimates and Reestimates

Based on our analysis, we believe that OMB provided little review and oversight of MARAD's estimates and reestimates. OMB has final authority for approving estimates in consultation with agencies; OMB approved each MARAD estimate and reestimate, explaining to us that it delegates authority to agencies to calculate estimates and reestimates. However, MARAD has little expertise in the credit reform area and has not devoted sufficient resources to developing this expertise. The FCRA assigns responsibility to OMB for coordinating credit subsidy estimates, developing estimation guidelines and regulations, and improving cost estimates, including coordinating the development of more accurate historical data and annually reviewing the performance of loan programs to improve cost estimates. Had OMB provided greater review and oversight of MARAD's estimates and reestimates, it would have realized the assumptions were outdated and did not track with actual recent experience.

Conclusions

In conclusion, Mr. Chairman, MARAD does not operate the Title XI loan guarantee program in a businesslike fashion. MARAD does not (1) fully comply with its own requirements and guidelines, (2) have a clear separation of duties for handling loan approval and fund disbursement functions, (3) exercise diligence in considering and approving modifications and waivers, (4) adequately secure and assess the value of defaulted assets, and (5) know what its program costs. Because of these shortcomings, MARAD lacks assurance that it is effectively promoting growth and modernization of the U.S. merchant marine and U.S. shipyards or minimizing the risk of financial loss to the federal government. Consequently, the Title XI program could be vulnerable to waste, fraud, abuse, and mismanagement. Finally, MARAD's questionable subsidy cost estimates do not provide Congress a basis for knowing the true costs of the Title XI program, and Congress cannot make well-informed policy decisions when providing budget authority. If the pattern of recent experiences were to continue, MARAD would have significantly underestimated the costs of the program.

Recommendations

We are currently considering a number of recommendations to reform the Title XI program, including actions Congress could take to clarify borrower equity contribution requirements and incorporate concentration risk in the approval of loan guarantees, as well as actions MARAD could take to improve its processes for approving loan guarantees, monitoring and controlling funds, and managing and disposing of defaulted assets. In addition, we are considering recommendations to help MARAD better implement its responsibilities under FCRA. Because of the fundamental flaws we have identified, we question whether MARAD should approve new loan guarantees without first addressing these program weaknesses.

This concludes my prepared statement. I will be happy to respond to any questions you or the other members of the Committee may have.

Contacts and Staff Acknowledgments

For further information on this testimony, please contact Mathew J. Scirè at (202) 512-6794. Individuals making key contributions to this statement include Kord Basnight, Daniel Blair, Rachel DeMarcus, Eric Diamant, Donald Fulwider, Grace Haskins, Rachelle Hunt, Carolyn Litsinger, Marc Molino, and Barbara Roesmann.

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